

SUMMARY ANALYSIS OF AMENDED BILL

Author: Harman Analyst: John Pavalasky Bill Number: SB 454
 Related Bills: See Prior Analysis Telephone: 845-4335 Amended Date: March 29, 2007
 Attorney: Daniel Biedler Sponsor: _____

SUBJECT: Trust Income Exempt From Tax If Trust Has No California Source Income and No Resident Beneficiaries

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

☒ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

☒ AMENDMENTS DID NOT RESOLVE THE DEPARTMENTS CONCERNS stated in the previous analysis of bill as introduced February 21, 2007.

☒ FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

☒ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED February 21, 2007, STILL APPLIES.

☒ OTHER – See comments below.

SUMMARY

This bill would limit California's ability to tax the income of certain trusts.

SUMMARY OF AMENDMENTS

The March 29, 2007, amendments would exempt from California taxation the income of any trust having one or more trustees that are California residents when the trust has no California source income and the trust beneficiaries all reside outside of California.

The discussions under THIS BILL and IMPLEMENTATION CONSIDERATIONS are updated and a new revenue estimate is provided reflecting the March 29, 2007, amendments. Additionally, the March 29, 2007, amendments raise a POLICY CONCERN that is discussed in this analysis. The remainder of the previous analysis of the bill as introduced February 22, 2007, still applies.

POSITION

Pending.

Board Position:

_____ S _____ NA _____ NP
 _____ SA _____ O _____ NAR
 _____ N _____ OUA ☒ PENDING

Legislative Director

Date

Brian Putler

4/13/07

THIS BILL

This bill would exempt from California taxation the income of a trust when the trust has no California source income and none of the beneficiaries are residents of California regardless of whether one or more of the trustees are residents of California. Stated in the affirmative, this bill would exempt from California taxation the income of a trust where one or more of the trustees is in California. This change in law would expressly apply “notwithstanding any other law to the contrary.” Thus, the exemption would apply to any trust, regardless of whether the trust is revocable or irrevocable, even when the grantor would otherwise be taxed on that “grantor trust” income as a resident of California.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author’s office to resolve these and other concerns that may be identified:

- It could be argued that use of the term “notwithstanding any other law to the contrary” means that this bill would allow a resident of California to create a “grantor trust” to avoid being taxed on the income from intangible assets such as stocks, bonds, notes, capital gain, or rights to receive income that are otherwise taxable to that resident. That “grantor trust” under this argument would be taxable only on income from California sources as a nonresident of California if it had only nonresident beneficiaries, even when the “grantor” retains the power to revoke the trust or has substantial control over the trust property or income. The author may wish to clarify that the bill would apply only to trusts where the separate existence of the trust is not disregarded under the “grantor trust” rules of current law.
- This bill also does not provide rules regarding the taxation of a California beneficiary receiving a distribution of accumulated income from the trust when that beneficiary was a nonresident in some of the years that the trust accumulated the income. That is, what rules does the California beneficiary use to determine the amount of tax to pay in the year of distribution whether the trust has paid California tax or not upon the accumulated trust income that is being distributed?

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this provision would result in the following revenue losses.

Estimated Revenue Impact of SB 454 Effective for Tax Years Beginning On or After 1/1/2007 Assumed Enactment Date After 6/30/07 (\$ in Millions)			
	2007/08	2008/09	2009/10
1. Grantor Trust Issue	Footnote A*	Footnote A*	Footnote A*
2. California Trustee Issue	-\$70	-\$70	-\$70

*Footnote A: The revenue loss of the grantor trust issue could potentially be in the tens of millions of dollars.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

1. Grantor Trust Issue

Under current law, in general, the income of a trust without California source income and without resident beneficiaries or trustees is not reported to California; however, if the grantor of a “grantor trust” is a California resident, the trust’s income, regardless of source, is reported on the grantor’s personal income tax return and taxed by California. The exemption from California tax in this bill would apply to the income of any trust even when the grantor would otherwise be taxed on that “grantor trust” income as a resident of California. Thus, this bill would allow a resident of California to create a “grantor trust” to avoid being taxed on the income from intangible assets such as stocks, bonds, notes, capital gain, or rights to receive income that are otherwise taxable to that resident.

The revenue impact is driven by the current amount of taxes paid on income of “grantor trusts.” The revenue loss would include the amount of taxes forgone by reclassifying taxable income as nontaxable income through the creation of “grantor trusts”.

As “grantor trusts” are treated as disregarded entities and the trust’s income is reported on the grantor’s personal income tax return, the amount of taxes currently paid on this income is unknown. Because of this and the uncertainty in the level of altered behavior, the revenue impact of this proposal is unknown. However, based on a review of currently reported taxable income that could be placed in “grantor trusts” (interest income, capital gains, and dividend income), the revenue loss could potentially be in the tens of millions of dollars.

2. California Trustee Issue

The revenue impact of classifying trust income as exempt from taxation, as in this bill, is dependent upon the amount of taxes paid by trusts without California source income, that have one or more trustees that are California residents, and have no beneficiaries that reside in the state.

The total amount of taxes paid by trusts that fit this specific fact pattern is unknown. For tax year 2005 approximately 305,000 trust returns reported a tax liability of \$650 million. Based on a sample of trust tax returns, it is reasonable to anticipate that a minimum of \$100 million in taxes could be associated with trust returns that have California trustees with beneficiaries that reside out of the state. Assuming that 35% of this tax liability is generated by trusts with no California source income, total revenue forgone could total approximately \$35 million in losses (\$100 million x 35% = \$35 million). It is anticipated that taxpayer’s would alter their behavior and create new trusts for all intangible assets to avoid income tax liabilities. The magnitude of altered behavior is unknown, but the revenue loss could reasonably double to \$70 million (\$35 million x 2 = \$70 million).

ARGUMENTS/POLICY CONCERNS

This bill would change long-standing California case law holding that California has nexus to tax the entire taxable income of a trust based on the protection afforded to the trustee by the state of California.

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